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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, NOVEMBER 17, 2000

APPLICATION OF

VIRGINIA ELECTRIC AND POWER COMPANY

CASE NO. PUF000021

For authority under Chapters 3, 4, and 5 of Title 56 of the Code of Virginia to participate in lease financing for construction of generation facilities, and for a declaration of non-jurisdiction

## ORDER

On July 5, 2000, Virginia Electric and Power Company ("the Company" or "Virginia Power") filed an application under Chapters 3, 4, and 5 of Title 56 of the Code of Virginia for authority to participate in a lease financing arrangement with an affiliate, for the construction of generating facilities.<sup>1</sup> Virginia Power proposes to finance approximately \$300 million, including interest and yield capitalized during construction, for the construction of generating facilities through a synthetic lease financing arrangement. Additionally, the Company has requested a declaration that the Commission will not assert jurisdiction over certain parties to the transaction. Based on its representations that other parties to the transaction will own the generating

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<sup>1</sup> By Commission Order dated October 3, 2000, in this case, the Commission authorized Virginia Power to enter into a financial transaction with its affiliate, DEI Sub ("DEI Sub"), pursuant to Chapter 4 of Title 56 of the Code

facility for financing purposes only, Virginia Power requests that the Commission issue a declaration of non-jurisdiction over these parties. The Company has paid the requisite fee of \$250 for its application.

On July 7, 2000, the Virginia Committee for Fair Utility Rates filed a Notice of Protest in this matter.

The generating facilities proposed by Virginia Power are the subject of a separate proceeding with the Commission, docketed as Case No. PUE000343. In Case No. PUE000343, filed on June 16, 2000, Virginia Power proposes to reconfigure the generating units at its Possum Point Power Station ("Possum Point") by taking two existing oil-fired units out of service, converting two existing coal-fired units to natural gas, and constructing a new combined cycle generating unit with a rated capacity of 540 megawatts ("New Facility").

On July 26, 2000, the Commission issued an Order Inviting Comments and Responses and Prescribing Notice in which it identified preliminary issues ("issues"), presented in Case Nos. PUF000021 and PUE000343, assigned a Hearing Examiner to make recommendations on the issues and required public notice. On September 1, 2000, the Hearing Examiner issued her report.

By Order dated July 27, 2000, entered in Case No. PUF000021, the Commission extended its authority to address the Chapter 3 aspect of this proceeding until thirty days after it decided the

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of Virginia, contingent upon the Commission's subsequent issuance of all additional required authorizations, approvals, and certificates.

issues identified in the July 26, 2000 Order. On October 18, 2000, the Commission issued an Order For Notice And Hearing in which it decided the preliminary issues.

According to the captioned application, Dominion Energy, Inc. ("DEI"), an affiliate of Virginia Power, will form a new subsidiary corporation, DEI Sub, to act as construction agent for the project. Additionally, two grantor trusts ("Trusts") unaffiliated with Virginia Power have been created to acquire the generation equipment from General Electric ("GE"). The Trusts will be combined to serve as the lessor of the New Facility. The Trusts will, under a Ground Lease, acquire from Virginia Power the real property at Possum Point on which the New Facility is to be constructed, will acquire the generation equipment from GE, and will cause the New Facility to be constructed.

DEI Sub will enter into a Supervisory Agreement to act as construction agent for the Trusts in connection with the construction, and thus will control the design and construction of the New Facility. DEI Sub will also enter into a synthetic lease ("Lease") for the New Facility from the Trusts. DEI Sub's payments under the Lease will be guaranteed by Dominion Resources, Inc. ("DRI"), parent company of Virginia Power and DEI. The Lease will have an initial term commencing on August 22, 2000, the date the lease was signed, and ending on the earlier of completed construction or August 1, 2003, followed by a base term, for a total of five years.

As described in the Company's response to Question No. 19 of the Staff's Second Set of Interrogatories and Request for Production of Documents, at the end of the Lease's initial term, the lessee, i.e., DEI Sub, may purchase the New Facility for the lease balance, renew the lease, or terminate the lease and sell the New Facility to a third party subject to any residual value adjustment clause.

Virginia Power will acquire operating control of the New Facility from DEI Sub under a sublease ("Sublease"). As represented by Virginia Power, the Sublease will contain essentially the same terms and conditions as the Lease. One difference is that the Sublease will not be executed until the New Facility is operational. The Sublease is a "triple-net" lease requiring Virginia Power to pay all maintenance, insurance, taxes, and other costs arising out of use or ownership of the leased property. Virginia Power will have the option on any payment date during the Sublease term to purchase the New Facility for an amount equal to the outstanding debt and equity. Interest will be capitalized during the construction period and will be financed as part of the project cost.

The Lease and Sublease are intended to qualify as operating leases for financial reporting purposes. Although the Trusts will be the record owner of the New Facility, it is intended that Virginia Power will be deemed to have ownership of the New Facility for federal income tax purposes. According to the

application, upon the expiration of the base term of the Sublease, Virginia Power will re-examine its permanent financing options in light of its overall capital structure and generation strategy.

Since Virginia Power will be permitted to acquire ownership of the New Facility at a fixed price, potential appreciation in the asset remains with Virginia Power. From a refinancing perspective, Virginia Power can buy or sell the New Facility or renew the synthetic lease upon its termination.

In light of the requested separation of Virginia Power's generation assets on January 1, 2002,<sup>2</sup> Virginia Power believes that it needs the flexibility afforded by synthetic lease financing. Further, Virginia Power's response to interrogatory No. 17 of the Staff's second set of interrogatories represents that the proposal for development of the New Facility will be affected by the transition to functional separation in the Company's November 1, 2000, Application for Approval of a Functional Separation Plan. This response indicated that the generating assets and functions proposed to be transferred to Dominion Generation include the New Facility. If the Functional Separation Plan is approved, upon completion of the construction another DRI subsidiary, Dominion Generation, would become the sublessee of the New Facility and operate the New Facility along

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<sup>2</sup> On November 1, 2000, Virginia Power filed an Application for Approval of Functional Separation Plan ("Functional Separation Plan") filed as Document Control No. 001110046.

with the other generating facilities proposed to be transferred to Dominion Generation under the Functional Separation Plan. Under this contingency, Virginia Power will not execute the Sublease.

NOW, upon consideration of the Company's application, representations by the Company,<sup>3</sup> the applicable statutes and rules, and having been advised by its Staff, the Commission is of the opinion and finds that approval of the application subject to the conditions set forth below will not be detrimental to the public interest.

On page 4 of the captioned application, Virginia Power states that the "primary purpose of the Possum Point project is to bring about environmental improvement while fulfilling the need to provide customers with adequate and reliable service in a cost-effective manner." Section 56-90 requires that the Commission find that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized by granting" any request for authority to acquire or transfer a utility asset. The Company represents that its acquisition of the New Facility, whose construction is proposed in Case No. PUE000343, is necessary and in the public interest to enable it to meet the

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<sup>3</sup> We note that in the Company's response to interrogatory question No. 15 of the first set of Staff interrogatories that Virginia Power stated that there is no legal basis under the present definitional framework for fuel expenses to consider the sublease payments to DEI Sub to be costs recoverable through its fuel factor. In addition, the Company represents to Staff that it does not presently have any intention of seeking fuel factor recovery of the lease payments or seeking necessary changes, if any, that would be required to allow such recovery. It would be difficult for the Commission to find that the

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synthetic lease arrangement is in the public interest if it were to cause fuel rates to increase when conventional financing would not cause that result.

obligation that it now has to provide adequate service to its customers at just and reasonable rates. We recognize, of course, that the Company's obligations are evolving under the law and that it has proposed that the supply of generation service, including the New Facility, should be transferred to Dominion Generation as part of the Company's plan of functional separation. This transfer issue related to the New Facility is, according to the Company, to be decided in the Functional Separation case it has filed.

A review of the relevant documents supporting the application in this case creates a concern that the Lease and Sublease may not clearly provide that the Company has the right to enter into the Sublease and thereby acquire control of the New Facility to the same extent as DEI Sub. Under the terms of the Lease and Sublease, DEI Sub will lease, develop, and control the New Facility until it becomes operational. It is unclear under the Lease and Sublease whether Virginia Power can maintain control over the New Facility under all stages of its development, i.e., in the same manner that it could if it were to finance and construct the New Facility by using traditional methods. We believe the Company needs assurance, given that the New Facility is said to be vital to its provision of service, that it will in fact be able to acquire and retain control of the New Facility upon its construction. Therefore, we will approve the application upon the reformation of the Sublease to the



extent necessary to assure that Virginia Power can maintain, to the extent practicable, the same control of the New Facility as DEI Sub may enjoy under the Lease. Obviously, such control need only continue until a further order is issued by the Commission finally adjudicating the issues presented in the Functional Separation Plan or in any other application regarding the facility. Since one of the purposes of this financing vehicle is to assure the completion of the New Facility to provide reliability to Virginia Power's system, then Virginia Power must be assured of continuing control over the New Facility and must be allowed to sign the Sublease.

We impose the conditions below simply to avoid what appears to be a slight possibility that the New Facility could be transferred from Virginia Power's control under circumstances that might jeopardize the Company's ability to provide adequate service to the public. This possibility is nowhere broached in the application or supporting materials, and indeed, it appears that the interests of DEI Sub and Virginia Power are now aligned.

Nonetheless, we direct Virginia Power to: (1) take all actions necessary to ensure that it will have the right to acquire control of the New Facility through the Sublease upon completion of construction; (2) reform the Sublease to the extent necessary to assure that Virginia Power can maintain, to the extent practicable, the same control of the New Facility as DEI Sub may enjoy under the Lease; (3) take all steps necessary to

obtain and assure the Company's continuing control over the New Facility under the Sublease as reformed, pending subsequent order of the Commission; and (4) obtain Commission authority before transferring control of the New Facility to any other entity. We anticipate, as does the Company, that the issue of transfer of control of the New Facility will be addressed as part of Virginia Power's pending Functional Separation Plan.

In order to assure the availability of the New Facility,<sup>4</sup> we find the following conditions necessary, at this time: (1) the determination regarding whether DEI Sub or other parties to this transaction are public utilities requiring certificates of public convenience and necessity shall be considered as part of Case No. PUE000343; (2) pending the resolution of the issue raised in condition (1) above, DEI Sub may not divest Virginia Power of control of the facility without Commission authorization to do so; (3) the real property subject to the ground lease approved herein may only be used to accommodate construction of the New Facility; (4) the approval granted herein is subject to further authorizations and conditions, and the issuance of appropriate certificates in Case No. PUE000343; and (5) the approval granted herein does not decide the issue of whether the New Facility is needed by Virginia Power. The issue of need identified in condition (5) herein will be determined in Case No. PUE000343, as

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<sup>4</sup> The issue of whether the New Facility should be constructed will be addressed in pending Case No. PUE000343. Consequently, we take no position relative to the issues presented by that case in this one.

part of our determination made under § 56-234.3 of the Code of Virginia.

Accordingly,

IT IS ORDERED THAT:

1) Virginia Power is hereby authorized to enter into the lease financing arrangement as described in its July 5, 2000 application, provided its supporting documents are modified as directed herein and are further subject to the conditions set out above.

2) Virginia Power shall take all necessary actions to ensure that it will have the right to acquire control of the New Facility through the Sublease upon completion of construction.

3) Virginia Power is directed to take all actions necessary to obtain and maintain control over the New Facility until ordered otherwise by the Commission.

4) The authority granted herein shall have no implications for ratemaking purposes.

5) The authority granted herein shall have no implications for the issues to be determined in the Company's pending Functional Separation Plan.

6) On or before December 4, 2000, Virginia Power shall file a copy of its modified Sublease and evidence of the requisite assurances set out in Ordering Paragraph 2) above with the Division of Economics and Finance.

7) This matter shall remain under the continued review, audit, and appropriate directives of the Commission.